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No. 17046 ✓

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CAL-NEVA LODGE, INC., a Nevada corporation,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

OPENING BRIEF OF APPELLANT CAL-NEVA LODGE, INC.

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FILED

FEB 14 1971

FEDERAL BUREAU OF INVESTIGATION

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Appellee.

**OPENING BRIEF OF APPELLANT
CAL-NEVA LODGE, INC.**

Specification of Error.

That the District Court erred in its Order of June 27, 1960, in reversing the Referee's Order of April 18, 1959, and in thereby allowing the claim of the United States.

Jurisdiction.

Appellate jurisdiction over the instant matter exists by virtue of the provisions of Section 24(a) of the Bankruptcy Act.

Facts.

On December 31, 1948, pursuant to an agreement entered into in the State of California [Tr. of R. p. 31], Appellant purchased the Cal-Neva Lodge from Elmer F. Remmer and Helen L. Remmer. Appellant executed

a first deed of trust on the Cal-Neva Lodge property in favor of the Remmers to secure the unpaid portion of the purchase price, the balance owing being evidenced by a note bearing interest at the rate of 4% per annum [Tr. of R. pp. 20, 21, 36].

Subsequently, the Remmers became involved in tax difficulties with the United States. On June 1, 1953, the United States served a levy upon Appellant under Section 3692 of the Internal Revenue Code of 1939, attempting thereby to seize the alleged indebtedness owing to the Remmers [Tr. of R. pp. 36, 37, 4, 7, 8, 11, 17]. As of June 1, 1953, the first trust deed in favor of the Remmers secured a principal balance in the sum of \$198,333.34 [Tr. of R. pp. 32, 37]. After the levy of June 1, 1953, Appellant sold the Cal-Neva Lodge property to Park Lake Enterprises, Inc., which agreed to assume the secured obligation to the Remmers [Tr. of R. p. 38]. The United States made no attempt to foreclose the Remmer trust deed on the Cal-Neva Lodge property subsequent to its levy of June 1, 1953 [Tr. of R. p. 32]. Appellant did not respond to the levy of the United States of June 1, 1953 [Tr. of R. p. 32]. An action by the United States against Park Lake Enterprises, Inc. to collect the alleged indebtedness to the Remmers is presently pending in the District Court of Nevada [Tr. of R. p. 21]. Appellant instituted proceedings under Chapter XI of the Bankruptcy Act on November 12, 1955 [Tr. of R. p. 29]. Thereafter the United States filed a proof of claim which was amended on several occasions seeking recovery from Appellant under Section 64 of the Bankruptcy Act of the sum of \$198,333.34 plus unpaid interest thereon at the rate of 4% per annum until June 1, 1953, plus interest at the rate of 6% per annum there-

after to the date of the petition on the principal and interest owing as of June 1, 1953 [Tr. of R. pp. 3-18]. Appellant filed its objections to the proof of claim of the United States [Tr. of R. pp. 18-20] which objections were sustained by the Referee [Tr. of R. pp. 20-25, 28-33]. The United States petitioned the District Court for review of the Referee's order [Tr. of R. pp. 26-28]. By its order of June 27, 1960, the District Court reversed the Referee and sustained the claim of the United States [Tr. of R. pp. 34-46].

Statutes Involved.

SECTION 57(j), BANKRUPTCY ACT:

“Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.”

SECTION 3710, INTERNAL REVENUE CODE OF 1939:

“Section 3710. Surrender of Property Subject to Distraint.

(a) Requirement. Any person in possession of property, or rights to property, subject to distraint, upon which a levy has been made, shall, upon demand by the collector or deputy collector making such levy, surrender such property or rights to such collector or deputy, unless such property or right is, at the time of such demand, subject to an attachment or execution under any judicial process.

(b) Penalty for Violation. Any person who fails or refuses to so surrender any of such property or rights shall be liable in his own person and estate to the United States in a sum equal to the value of the property or rights not so surrendered, but not exceeding the amount of the taxes (including penalties and interest) for the collection of which such levy has been made, together with costs and interest from the date of such levy.”

Issues Presented.

1. Where the United States levies upon a person indebted to its taxpayer, does it acquire any better rights against the person levied upon than those possessed by its taxpayer?

2. Does state or federal law determine the nature and extent of the property or rights to property in possession of the taxpayer's debtor at the time of a levy on said debtor by the United States?

3. Where by the law of the state the taxpayer, by virtue of his being the beneficiary of a purchase money trust deed, is entitled to no deficiency against his trustor-debtor, and must look only to his security, may the United States ignore the security and levy upon the trustor-debtor and thereby force him to pay over the principal indebtedness?

4. Does Section 57(j) of the Bankruptcy Act require the disallowance as a penalty of a claim by the United States against the estate of a debtor under Section 3710(b) of the Internal Revenue Code of 1939 where the United States has contributed nothing to the debtor's estate and has suffered no loss by virtue of the debtor's failure to respond to a demand made under Section 3710(a) of the Internal Revenue Code of 1939?

ARGUMENT.

I.

By Its Levy Under Section 3692 of the Internal Revenue Code of 1939 the United States Acquired No Better Rights Against Cal-Neva Lodge, Inc., Than Those Possessed by Its Tax Debtor.

Section 3692 of the Internal Revenue Code of 1939 created a “. . . statutory attachment and garnishment in which the service of notice provided by statute takes the place of the court process in the ordinary garnishment proceeding.” *United States v. Eiland* (C. A. 4th), 223 F. 2d 118, 121. A creditor seeking to reach an indebtedness owing to his debtor by a third person by attachment or garnishment acquires no greater rights against the third person than those possessed by his debtor, even though that creditor is the sovereign. *United States v. Winnett* (C. A. 9th), 165 F. 2d 149. “Under Section . . . 3710(a) of the Internal Revenue Code . . . the rights of the Collector do not extend beyond those of the taxpayer whose right to property is sought to be levied upon.” *United States v. Winnett, supra*, at p. 151. See also *United States v. Graham*, 96 Fed. Supp. 318, aff’d *per curiam sub. nom. State of California v. United States* (C. A. 9th), 195 F. 2d 530, cert. den., 73 S. Ct. 36.

II.

State Law Determines the Rights to Which the United States Succeeded by Virtue of Its Levy.

Federal tax lien statutes create no property rights but merely attach federally defined consequences to property rights created under state law. *United States v. Bess*, 78 S. Ct. 1054; *United States v. Winnett* (C. A. 9th), 165 F. 2d 149; *United States v. American Nat. Bank of Jacksonville* (C. A. 5th), 255 F. 2d 504; *Fidelity & Deposit Co. v. New York City Housing Authority* (C. A. 2d), 241 F. 2d 142. Thus, it has been held that a tax lien arising prior to the death of a taxpayer could reach only the cash surrender value of the taxpayer's policies of life insurance which was available to him at the time of his death rather than the full proceeds of the policies payable to his beneficiary by virtue of his death, for the reason that the taxpayer's property interest at the time of levy was limited by the policy contract as enforced by state law to the cash surrender value only, *United States v. Bess, supra*; that a tax lien perfected against a taxpayer prior to the execution of a mortgage by the taxpayer and his spouse on real property held by them as tenants by the entirety could not defeat the subsequent mortgage for the reason that under state law the taxpayer's interest in a tenancy by the entirety is not one which is subject to attachment or in any manner lienable, *United States v. American Nat. Bank of Jacksonville, supra*; that a levy upon a taxpayer's debtor did not deprive the debtor

of his right of offset against the taxpayer because by state law, the debtor had an equitable right of offset at the time of levy, *United States v. Winnett, supra*; and that a fund allegedly payable to a taxpayer by a housing authority for construction services rendered was not a lienable property right for the reason that under state law the taxpayer's failure to pay material and labor claims divested him of any interest in said fund. *Fidelity & Deposit Co. v. New York City Housing Authority, supra*.

Since it is a defense to a levy under Section 3692 and a demand for surrender under Section 3710 that the person levied upon was not in possession of any property of the taxpayer which was subject to levy, *Bank of Nevada v. United States* (C. A. 9th), 251 F. 2d 820, it therefore becomes necessary to look to state law to determine whether or not Cal-Neva Lodge, Inc., was in possession of any property of the Remmers which was subject to levy on June 1, 1953.

III.

Cal-Neva Lodge, Inc., Was Not Indebted to the Remmers as of June 1, 1953, the Date of Levy by the United States.

The deed of trust given the Remmers by Cal-Neva Lodge, Inc., on December 31, 1948, in lieu of a portion of the purchase price was a purchase money trust deed. *Peterson v. Wilson*, 88 Cal. App. 2d 617.

In California there is only one form of action available to a mortgagee holding a mortgage securing a de-

faulted note who desires a personal judgment against his mortgagor and that is for a judicial foreclosure and deficiency determination. Section 726, California Code of Civil Procedure. Section 726 of the California Code of Civil Procedure applies to trust deeds as well as mortgages. *Bank of Italy v. Bentley*, 217 Cal. 644.

In an agreement wherein a non-purchase money trust deed is utilized to secure a note obligation, borrower and lender impliedly contract that the land will constitute the primary fund to secure the debt and that a valid sale under the deed of trust is a prerequisite before any action can be maintained on the note. *Bank of Italy v. Bentley, supra*.

Not only does Section 726 of the California Code of Civil Procedure limit the beneficiary of a trust deed to one form of action, but also, Section 580b of the California Code of Civil Procedure deprives that beneficiary of any right to a deficiency where his trust deed is of the purchase money variety. *Brown v. Jensen*, 41 Cal. 2d 193. Further, it has been held that in a purchase money transaction, there is no debtor-creditor relationship between buyer and seller, the seller having only a security interest in the land to the extent of the balance due. *Jeanese v. Surety Title & Guaranty Co.*, 176 Cal. App. 2d 449.

IV.

The Levy by the United States on Cal-Neva Lodge, Inc., Under Section 3692 of the Internal Revenue Act of 1939 Was Meaningless in That the United States Failed Thereby to Seize Any Property or Rights to Property of Its Tax Debtors.

By its levy of June 1, 1953 the United States, standing in the shoes of the Remmers, *United States v. Winnett* (C. A. 9th), 165 F. 2d 149; *United States v. Graham*, 96 Fed. Supp. 318, aff'd *per curiam sub. nom. State of California v. The United States* (C. A. 9th), 195 F. 2d 530, cert. den., 73 S. Ct. 36, and possessed of only those rights had by the Remmers under state law, *United States v. Bess*, 78 S. Ct. 1054; *United States v. American Nat. Bank of Jacksonville* (C. A. 5th), 255 F. 2d 504; *United States v. Winnett, supra*; *Fidelity & Deposit Co. v. New York City Housing Authority* (C. A. 2d), 241 F. 2d 142, reached no indebtedness owing by Cal-Neva Lodge, Inc. to the Remmers, Section 726, California Code of Civil Procedure; Section 580b, California Code of Civil Procedure; *Jeanese, Inc. v. Surety Title & Guaranty Co.*, 176 Cal. App. 2d 499, which rendered it a creditor of Cal-Neva Lodge, Inc.

There being no seizure of any property or rights to property of the Remmers by virtue of the levy by the United States on June 1, 1953, Cal-Neva Lodge, Inc. had nothing to surrender to the United States under Section 3710(a) and accordingly could not be made liable in its own person to the United States under Section 3710(b). (*Bank of Nevada v. United States* (C. A. 9th), 251 F. 2d 820.) It would be indeed anom-

alous to view as “property” subject to lien, funds of Cal-Neva Lodge, Inc. which never were within the Remmers’ reach to enjoy. (*United States v. Bess, supra.*)

V.

The Claim of the United States Against Cal-Neva Lodge, Inc., Under Section 3710(b) of the Internal Revenue Code of 1939 Is a Penalty and Must Be Disallowed Pursuant to the Provisions of Section 57j of the Bankruptcy Act.

“Debts owing to the United States . . . as a penalty or forfeiture shall not be allowed, except for the amount of pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.” Section 57j, Bankruptcy Act.

The purpose for the enactment of Section 57j was to limit as far as possible the losses to be sustained by general creditors of a bankrupt. (3 Collier on Bankruptcy, Section 57.22.) Participation in the estate is to be denied “to a creditor who has neither in some degree contributed to the distributable funds . . . nor has suffered a pecuniary loss by parting with something in money’s worth.” (2 Collier on Bankruptcy, Section 57.22 at p. 297.)

Section 57j was intended to exclude from participation in the assets of a bankrupt estate “the bulk of fines, penalties, and other financial sanctions whose function in no way differs from that of most criminal laws in that they neither compensate for a financial loss suffered by the estate nor open a source of revenue, but

merely regulate human behavior through the threat of financial retribution.” (3 Collier on Bankruptcy, Section 57.22 at p. 296.)

The levy made by the United States against Cal-Neva Lodge, Inc. under Section 3692 of the Internal Revenue Code of 1939 was not made for the purpose of securing the United States for an indebtedness owing to it by Cal-Neva Lodge, Inc., but was made for the purpose of seizing a claimed indebtedness owing to the United States by the Remmers. Accordingly, insofar as the sums at issue are concerned, the United States contributed nothing to the distributable funds of Cal-Neva Lodge, Inc.

The United States suffered no loss by parting with something in money's worth to Cal-Neva Lodge, Inc. Cal-Neva Lodge, Inc. did not cause the United States to be deprived of its recovery rights by its transfer of the Cal-Neva Lodge property to Park Lake Enterprises, Inc. The transfer of said property was made with the express assumption of the secured obligation to the Remmers by Park Lake Enterprises, Inc. The right of the Remmers in and to the Cal-Neva Lodge property continued in existence. In fact, the United States has proceeded against Park Lake Enterprises, Inc. to recover the Remmer interest.

By its very terms, Section 3710(b) is denominated as a “Penalty for Violation.” “Statutes generally refrain from calling the sanction for non-payment a fine or penalty, because if they do not take that precaution but call a penalty a ‘penalty’ they expose their claim to prompt disallowance.” 3 Collier on Bankruptcy, Section 57.22 at p. 301; *District of Columbia v. Greenbaum*, 223 F. 2d 633.

In attempting to proceed against Cal-Neva Lodge, Inc. under Section 3710(b), the United States is seeking to impose a personal liability upon Cal-Neva Lodge, Inc. for its failure to respond to the levy under Section 3692 of the Internal Revenue Act of 1939. (*Sims v. United States*, 79 S. Ct. 641.) A recovery against Cal-Neva Lodge, Inc. under Section 3710(b) would not limit the right of the United States to still pursue the Remmers for the collection of the tax indebtedness which was the subject of the initial levy against Cal-Neva Lodge, Inc. under Section 3692. (*United States v. Peoples State Bank* (D. C.), 53-2 U. S. T. C., Par. 9655.)

In *United States v. Peoples State Bank*, *supra*, the court stated as follows:

“The checking account of a delinquent income taxpayer in a local bank was subject to distraint under 1939 Code Section 3710(a). By its failure to pay the collector the amount levied against it within five days of the date of the final notice and demand, the bank became personally liable for this amount, plus interest thereon, notwithstanding the continuing liability of the taxpayer for an equivalent amount, pursuant to Section 3710(b).”

It can be seen that the claim asserted by the United States against Cal-Neva Lodge, Inc., under Section 3710(b) is not based upon a contribution rendered to the assets of Cal-Neva Lodge, Inc. but rather is one, that has for its purpose, the regulation of human behavior through the threat of financial retribution. Accordingly, the claim of the United States falls within the bar of Section 57j of the Bankruptcy Act and must be disallowed.

Conclusion.

Wherefore, Appellant prays:

1. That the Order of the District Court, dated June 27, 1960, sustaining the levy of the United States of June 1, 1953 be reversed.
2. That the Order of the Referee, dated April 18, 1959, be affirmed.
3. That Appellant recover of Appellee its costs on appeal.

Respectfully submitted,

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